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Governing Criminal Markets:

The Role of Private Insurers in Kidnap for Ransom

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Abstract

Who orders and facilitates the interactions between private individuals and criminals engaged in transnational kidnap for ransom? Past work shows that organised crime groups govern grey and criminal markets, while private firms often fill the formal governance vacuum in legal international transactions. The intersection between the formal and criminal economies presents a range of intractable coordination and enforcement problems. I argue that a unique group of insurers at Lloyd's have created contracts, protocols, norms, and agencies especially suited to this unusual market. They minimise the kidnapping of insured workers, high net-worth individuals, and tourists. They also ensure that hostages are treated well, coordinate to keep ransoms moderate and stable, and discourage kidnappers from reneging on agreed ransoms. Prevention and orderly resolutions create a profitable market for kidnap insurance. Understanding this governance architecture is crucial for remedying current trends in "terrorist" kidnap for ransom.

Key Words: Kidnap for ransom, Insurance, Self-Governance, Lloyds

JEL Classifications: K42, L84, P48

Introduction

Thousands of people are kidnapped worldwide every year. Employees of multinational organisations, contractors, business travellers, and high-net-worth individuals are particularly attractive targets. Kidnaps are frightening – and potentially complicated and expensive to resolve. Total annual ransom payments are estimated at up to US\$1.5bn (The Independent, 2010; Catlins, 2012, Agenda Week, 2012). In recent years buying kidnap and ransom insurance has become an accepted cost of doing business in conflict-ridden, stateless, and weakly governed territories (The Economist 2006, 2013, Kenney 2007/08, Fink and Pingle 2014). Yet, kidnap for ransom - and its insurance - would not be possible without effective norms and protocols to order the trade in hostages and without institutions to enforce and maintain them. This paper argues that insurers provide governance at the ragged intersection between the legal and criminal economies, thereby introducing a new agent to the study of extra-legal governance. I provide a detailed analysis of the complex governance architecture developed by insurers to stabilise kidnapping, guide their customers' interaction with the criminal underworld, and facilitate orderly transactions.

Transnational kidnaps have several features which (in combination) make self-governance particularly intractable and interesting to study (Greif 2005, Munger 2010). Often kidnap victims are picked opportunistically, creating a random pairing of agents for a one-off transaction.¹ Bargaining takes place under incomplete information regarding the victim's financial situation and the kidnapper's criminal capital. Both sides have strong incentives to

¹ Although some gangs target VIPs, most kidnappers do not know the identity of their victims ex ante when "logo hunting", targeting expensive cars, ships, hotels, oil platforms or business premises. See Hagedorn Auerbach (1998 p30-36).

misrepresent their situation.² Kidnappers can employ violence to extract information and concessions.³ Killing some hostages may raise the price offered for others.⁴ This anarchic bargaining is followed by a clandestine, sequential exchange. Even if both parties act in good faith, the hand-over may be intercepted by law enforcement or other criminals.⁵ There is no redress if either party cheats or reneges on the deal. Victims generally do not broadcast their experiences, but information-sharing is essential for multi-lateral enforcement mechanisms (Greif 2005).⁶ This set-up would lead us to expect lengthy, messy, and potentially brutal negotiations with uncertain outcomes. Media coverage of kidnap cases with gruesome conclusions confirm this impression. Yet, most criminal kidnap cases are resolved remarkably smoothly and extremely discreetly – especially when the victims are insured. Very few insured hostages are killed, violence (while often threatened) is limited, and hostages are usually released after ransoms are paid (Lobo-Guerrero 2007, Lopez 2011, Merkling and Davis 2001). Moreover, ransoms in insured kidnap cases are generally predictable, low, and stable (Catlins 2012, Bankrate 2012, Shortland 2016). The degree of order observed in insured kidnaps suggests the presence of effective institutions of governance to regulate exchange.

² For “local-on-local” kidnaps there is better information on individuals’ wealth.

³ The “quality of the goods” (i.e. the state of the hostage) is only revealed after the exchange.

⁴ See Leeson 2010 on “torture for reputation”.

⁵ This creates an incomplete monitoring situation, where parties may mistakenly believe that cheating occurred.

⁶ Families and firms do not want to publicly advertise that they paid a ransom. For “local-on-local” kidnaps discreet communication between victims creates a shadow of the future.

This contrasts starkly with terrorist kidnaps, where insurance is proscribed.⁷ Torture and murder are common and million dollar ransoms generate further kidnaps (NYT 2014, Sandler et al 2016). Terrorist kidnaps are highly politicised: the human security of the hostage must be weighed against governments' broader security aims (UN 2013, White House Briefing 2015). Most governments officially adopt a "no negotiation" policy, but several are known to negotiate on behalf of their citizens (NYT 2014, Sandler et al 2016). Democratic governments have a poor track record in limiting ransom payments – especially if they are officially committed to not negotiating at all (Lee 2013, Browne and Dickson 2010). This puts the lives of citizens of non-negotiating nations in peril: if a group holds multiple hostages, murder and *"torture-for-reputation"* can raise overall pay-offs (Leeson 2010). Where it is politically infeasible to deprive citizens of their right to life, governments may permit private resolutions (Block and Tinsley 2008, White House Briefing 2015). This paper examines the private governance structures which preserve lives and limit ransoms in criminal kidnaps. An appreciation the complexity of this governance architecture is central for future political initiatives to order terrorist kidnap for ransom.

The extra-legal governance literature analyses institutions ordering a wide range of criminal and informal markets. Transnational kidnaps add an interesting dimension to this literature as they straddle legal and illegal markets and require extraterritorial governance.⁸ Criminal markets – e.g. drugs, prostitution, informal credit, and contraband – are highly

⁷ Section 17A of UK Counter-Terrorism and Security Act 2015 states that it is a criminal offence to reimburse a ransom with actual knowledge or reasonable cause to suspect that it was paid to terrorist groups.

⁸ See also Leeson and Nowrasteh's 2011 "plunder contracts" between 18th century pirates and their victims.

vulnerable to opportunistic behaviour and predation. This creates demand for protection and enforcement. Criminal market governance is usually analysed through the lens of “protection theory” (Varese 2014). Mafias and other providers of informal governance such as clans and prison gangs can provide genuine services, e.g. dispute resolution, enforcement of informal contracts, retrieval of informal credits, and protection from harassment (Gambetta 1993, Leeson and Rogers 2009, Skarbek 2011, 2014, Varese 2001, 2010, 2014). The distinguishing feature of mafias is their power to settle issues by (lethal) violence: punishments raise the cost of non-co-operation and cheating (Leeson and Rogers 2009).

Mafias often provide quasi-state services (Bates et al 2002, Shortland and Varese 2015). These may exist in parallel to state structures where trade partners prefer (fast and effective) mafia protection, dispute resolution and contract enforcement to state services (Skaperdas 2001, Gambetta, 1993). Mafias can therefore bridge the legal / illegal divide. However, the mafias’ ability to govern is limited to the territory where they can reliably deliver violence. Varese (2011) discusses the considerable obstacles to mafia transplantation and Campana (2013) shows that although mafias may conduct criminal activities outside their territory, they do not provide extraterritorial protection. Providers of extra-legal governance often facilitate the resolution of local kidnaps (e.g. Safer Yemen 2014), but they are not well placed to order (extraterritorial) transnational kidnaps. I argue that this governance space is largely filled by private insurers, which have not been considered as providers of governance in criminal markets so far.

The literature on private governance in international transactions deals with a similar problem of extra-territoriality: states can only provide international governance cooperatively and are often unable (or slow) to develop the necessary institutions to do so.

Private firms have therefore created a plethora of norms, institutions and regimes to fill this governance vacuum (Cutler et al 1999, Stringham 2015, Jakobi 2015). Insurers have already received attention as providers of private governance in international affairs (Cutler et al 1999, Haufler 1997, 1999). The focus has been on the interaction between insurers and governments (particularly as regards what is “insurable”) and insurers and their customers. Insured risks are to a significant extent controlled by policy-holders whose motivation to limit losses is reduced by obtaining insurance. Consequently, insurers must constrain opportunistic behaviour by their customers (Heimer 1985, Lobo-Guerrero 2007). However, no explicit attention has yet been paid to the role of insurers in ordering transnational criminal transactions.

Crime and insurance are interlinked. Crime creates a demand for insurance and insurance can create additional criminal opportunities through moral hazard. Demand for insurance depends on risk perception. As one business insider explains: *“Inquiries [for kidnap insurance] surge so predictably after well publicised crimes that I can almost plot it on a chart...”* (The Economist 2006). This leads some commentators to suspect a “conspiracy” or “racket” between insurers and criminals (Clendenin 2006/2007, The Times 2012). Yet, when crime rates or the cost of resolution rise and insurance premia go up, or the crime is unpleasant, firms (and individuals) avoid the risks instead (Camacho and Rodriguez 2013, Pshisva and Suarez 2010). Profit-maximising insurers therefore should not treat crime as exogenous. In kidnap for ransom, insurers need to prevent casualties, effect quick resolutions, and keep ransoms within a reasonable range. If governance is successful, the demand for kidnap insurance is high and premium income reliably covers any arising claims, leaving a profit for insurers.

The paper examines the different norms and agencies of governance created by the insurance industry to govern kidnap for ransom. The governance regime constantly evolves: rules and procedures respond to market incentives, regulation, and legislation. Protocols differ across regions, over the insured activities, and among insurers. Many governance functions are carried out by close-knit communities of experts, where information and best practice are shared informally. There is a competitive market for expert services where excellence and successful innovations are rewarded. Failures in prevention and bungled resolutions lead to (heavy) financial losses, often followed by market exit. Certain standards and protocols required to stabilise the overall market are maintained through Lloyd's of London, where the vast majority of kidnap for ransom insurance is underwritten (Shortland 2016).

On the whole, privately created (informal) governance of kidnap for ransom functions well in difficult circumstances. Governance failure provides the impetus to innovate and adapt. Insurers do not have an incentive to reduce crime to zero, but they keep the volume of criminal transactions at a low level - limiting the impact of crime on the legal economy. This has important policy implications for dealing with terrorist kidnaps.

2. Data Collection

Kidnap for ransom, and its insurance and resolution, are a highly discreet business: knowledge that people are insured makes them targets and raises kidnappers' ransom expectations (March 1988, Lobo-Guerrero 2007, Ochoa 2012). Criminals would value information about ransom negotiations and the profitability of kidnaps. Information is also not made public because of the distress it might cause kidnap victims. For all these reasons,

it is difficult to “get inside” the kidnapping business. Other than Lobo-Guerrero 2007, there is little detailed academic research on how kidnap for ransom insurance works in practice. To overcome this problem, this research is based on 25 in-depth interviews and reflective conversations with “crisis response” consultants from several firms, risk analysts, insurers, lawyers and victims, often followed up with e-mail correspondence.⁹ Some consultants brought in tapes of ransom negotiations and Per Gullestrup of Clipper Shipping (Interview X) made the complete FBI transcript of a pirate ransom negotiation available. Control Risks – a major business risk consultancy - provided anonymised data from its global Kidnap for Ransom database. This combines private and open source information on kidnapping and is the data source for their global risk map product.¹⁰

Most interviewees wished to remain anonymous and none of the conversations were recorded. Handwritten notes taken during interviews were summarised and direct quotes agreed afterwards, but no-one gave permission to publish the summaries, while others did not wish the material or the interview to be referred to at all. The references provide some information on the 16 people who agreed that the interview could be referred to.¹¹ I therefore referenced open source material instead, including memoirs written by former negotiators (Clutterbuck 1978, 1987, Lopez 2011, March 1988, Wright 2009).

⁹ Seven of the interviewees were direct contacts. The other interviewees were obtained by snowballing through their professional networks.

¹⁰ <https://www.controlrisks.com/riskmap>

¹¹ With the exception of Interview XV the sources were male. All were professionals, Anglophone, white and ages ranged from mid-thirties to mid-seventies.

3: Governed vs Ungoverned Kidnap Markets

Kidnap for ransom insurance was first developed by Lloyd's of London following the infamous abduction of Charles Lindbergh's young son in 1932, as a boutique product for wealthy individuals and top executives (Clutterbuck 1987, Economist 2006, Fink and Pingle 2014). Initially, ransoms were negotiated and delivered by the family or corporate stakeholders and subsequently reimbursed by the insurers (Clutterbuck 1978). The 1970s saw an escalation of high profile kidnappings in the US, Italy, and Latin America (Clutterbuck 1978, Lewis 2002). Fourteen of the 18 highest known ransoms were paid between 1972 and 1975 rising from US\$1million to US\$60million (Business Insider 2012). Many cases involved torture and deliberate mutilation and some victims died (Clutterbuck 1978, Lewis 2002). If this trajectory had continued unchecked, kidnap would have become uninsurable.

In response, insurers developed governance mechanisms for the prevention and resolution of kidnaps. These have become highly effective over time. Data provided by crisis response companies specialised in resolving kidnaps indicate that in the last twenty years less than 2% of insured ransom negotiations ended with a dead hostage.¹² The market leader, Control Risks, only "lost" eight hostages between 2000 and 2014 - a rate of less than 0.5%.¹³ Deaths are generally attributable to pre-existing medical conditions, rescue and escape attempts (Interview III, IV, V). Murder is highly unusual: *"People are not killed as part of the*

¹² Interviews III, IV, V, Lobo-Guerrero 2007

¹³ Personal communication Control Risks January 2016

process” (Interview IV). Consequently, potential victims are strongly advised to cooperate with their captors and wait patiently to be ransomed (ODI 2010).¹⁴

Uninsured victims can take none of this for granted. For example, the 4 Thai sailors released by Somali pirates in February 2015 after more than five years in captivity had gone *“through a long-time horrific ordeal in which their captors often used torture...”* during which most of the crew died (Bloomberg 2015). Murphy (2012) wrote about the hostages of the Iceberg and Orna, also taken by Somali pirates: *“...the general rule is: No insurance – no freedom”*. The average percentage of people killed in kidnaps is estimated at around 9% - making fatalities in uninsured cases considerably higher than for insured cases (Lobo-Guerrero 2007).

Many governments have outlawed ransom payments and the reimbursement of ransoms paid to “terrorist” organisations: insurers can only order “criminal” cases.¹⁵ Where “terrorist” and “criminal” kidnap businesses co-exist, the outcomes are quite distinct.¹⁶ Firstly, governments pay more: Foreign Policy 2015 reports that *“...ransoms paid for hostages taken by al Qaeda in the Islamic Maghreb averaged more than \$5 million in 2012, while criminal kidnappings covered by insurance in the same geographical region were often resolved for about \$80,000.”* Secondly, “terrorists” are generally more violent. Hagedorn

¹⁴ Consultancies have an incentive to overstate their quality, but the community is sufficiently small for misrepresentations to be found out. I cross-checked the information and found experts were well informed about competitor performance. The ODI 2010 “good practice” advice indicates that NGOs trust in the smooth functioning of the ransoming process.

¹⁵ People can buy kidnap insurance even if the ransom payment cannot be insured. Incentives to do so are reduced where the majority of kidnappers are suspected terrorists.

¹⁶ Different markets coexist if governments disagree on whether an organisation should be proscribed. Otherwise we can compare outcomes before and after the “terrorist” label is applied.

Auerbach (1998 p119) reports Indian High Commission data on kidnappings in Kashmir from 1990-1995. Around 2000 hostages were taken, of which 50% were known to have been killed, 25% returned (often barely) alive and 25% were still missing. The Al Qaeda and IS strategy of torturing and beheading hostages (especially those for whom no ransom is offered) is reminiscent of the “*torture-for-reputation*” strategy employed by late 17th and early 18th century pirates. Leeson (2010) showed that a reputation for “madness” (i.e. destroying valuable goods) and “fiendish” torture - although costly in the short-term - enhanced long-term pay-offs. Yet, criminal kidnapping gangs rarely adopt shock tactics and those which do tend not to survive long (New York Times 1998, Ochoa 2012).

The distinction between “criminal” and “terrorist” modes of kidnap is well-known in the corporate world. Sometimes it is a political choice whether kidnappers are labelled as “terrorists”. As evidence mounted that radical Islamist group *Al-Shabab* benefited from Somali pirate ransoms (The Guardian 2009, Reuters July 2011, Shortland and Varese 2015), ship-owners strongly lobbied for the “criminal” label and hence the continued insurability of Somali piracy (The Guardian 2009). Indeed, the UK Piracy Ransoms Taskforce in 2012 decided not to criminalise pirate ransoms as initially intended (Interview IX, FCO 2012).

In summary, a sea-change occurred in kidnap for ransom in the mid-1970s, but this change was specific to insured cases. There is a clear distinction between transactions governed by insurers and those resolved privately or by governments: both hostage mortality and ransoms are significantly lower among the insured. The following sections analyse how insurers govern criminal kidnap for ransom.

4. Governing Kidnap for Ransom

The demand for insurance is positively related to risk perception and loss severity, but negatively to the insurance premium. There is a range of kidnap intensities and ransoms at which insurance is viable. Beyond an optimum risk level, however, passing on the higher cost of resolutions by raising insurance premia reduces the demand for insurance sufficiently to impinge on insurers' profits.¹⁷ Insurers therefore have an economic incentive to limit kidnapping and control the cost of resolution. In addition, supplying attractive insurance products – such as annual policies – requires stability. To price long-term insurance correctly kidnap volumes and the cost of resolution must be predictable. If ransoms escalate, there are supernormal returns to kidnapping and new gangs enter the market (Hagedorn Auerbach 1998, Shortland 2015, UN 2013, Wright 2009). The emergence of “kidnapping booms” and “hot-spots” indicates that kidnaps and ransoms can exhibit unstable dynamics.¹⁸ This may cause unexpected heavy losses for insurers. Adjusting criminals' ransom expectations downward requires patient bargaining (Ambrus et al 2015). Maintaining ransom discipline is therefore crucially important: kidnapping must be “governed”.

There is considerable debate in the political science literature on what constitutes “good governance” (Agnafors 2013). Scholars generally identify different “dimensions”, “domains” or “components” of governance. “Good” or “effective” governance requires that each component is satisfied at least at some threshold level (Agnafors 2013, Salter 1999, 2001). Aligica and Tarko (2013) point out that institutions can be co-produced by different actors working for individual profit. This section outlines how governance of kidnap for

¹⁷ Modelling this complex relationship is beyond the scope of this paper.

¹⁸ See for example the kidnap risk mapping at <https://riskmap.controlrisks.com/>

ransom is co-produced in the various domains by private legal firms, criminals and governments.

4.1. Domains of governance in kidnap for ransom

Given the complexity of the problem, I split it into three different issue areas or “domains” of governance, following Salter (1999, 2001). Firstly, insurers must address adverse selection (i.e. refuse insurance to reckless customers) and discourage moral hazard: their customers must remain vigilant. Domain (A) in Table 1 below therefore focuses on insurance contracts. Secondly, insurers need to make kidnapping difficult, so domain (B) is the “Prevention” of kidnaps. Thirdly, insurers must incentivise kidnappers to refrain from violence and encourage their customers to maintain ransom discipline. Domain (C) is hence labelled “Resolution”.

4.2. Regulation functions

It is also useful to split governance into three regulation functions: standard-setting, monitoring & evaluation and intervention (Salter 1999, 2001). Each cell within the matrix of table 1 thus constitutes an essential governance function. Standard setting underpins the smooth functioning of the market. The standards must be adaptable: criminals respond to local political and economic change, law enforcement initiatives, corrupt state structures, and learn from past interactions. Insurers also respond to business demands for specific products and value-for-money, as well as government legislation. Although there are some basic standards, “best practice” is never static.

The second regulation function is monitoring and evaluation. This is to ensure that best practice standards are fit for purpose and correctly implemented by all relevant market participants. The monitoring of correct implementation is carried out by various experts: underwriters, reinsurers, brokers, loss adjusters, risk consultants and hostage negotiators. Monitoring is also carried out by criminals: kidnapping gangs test the effectiveness of the insureds' risk mitigation strategies and identify inept negotiators generating large resolution costs. Evaluation is easy: insurers who fall short of best practice lose market share and sustain (heavy) losses. The profit motive ensures a speedy correction or market exit.

The third regulation function is intervention. A credible threat of sanctions ensures compliance by customers and competitors and incentivises experts to provide high quality services. Intervention happens mostly at the firm level: unlucky and inept experts are dismissed. Further intervention functions are carried out by the courts, where firms can be sued for breach of their "care of duty" towards their employees. Finally, Lloyd's of London, where the vast majority of kidnap for ransom insurance is underwritten can close member syndicates which destabilise the market (Shortland 2016).

- Insert Table 1 here -

4.3. Co-production of governance

Although the key actors in devising the governance architecture are private insurers, the governance architecture is more accurately described as polycentric (Aligica and Tarko 2013). Criminals carry out important functions in kidnap for ransom governance: in search of private profit they "monitor" the effectiveness of prevention measures and the quality of negotiators. Kidnapping of unaware and undefended customers and high ransoms set in motion the evaluation and intervention process. The "quality of crime" in a particular area

influences the standard-setting process of the insurers – and mafias may be employed in providing security for customers where states permit mafias to control territory. Governments play an important intervention role. The state enforces contracts between insurers and their customers and the threat of being sued keeps both customers and non-customers compliant with “best practice” standards. The shading in table 1 therefore indicates significant co-production of governance between states, insurers and criminals.

5. The Practice of Governing Kidnap for Ransom

5.1 Governance Domain (A): Insurance Contracts

As Fink and Pingle (2014) observe, kidnap insurance is only welfare-improving if it does not raise the risk of kidnapping significantly. This requires careful management of moral hazard and adverse selection (Heimer 1985). A standard procedure has emerged in kidnap for ransom. Access to and the terms of insurance are controlled by expert underwriters. Globally, there are less than 20 insurers underwriting and reinsuring kidnap and ransom products, all of which maintain syndicates at Lloyd’s of London (Shortland 2016). Expert underwriters work in the Lloyd’s Lyme Street trading room, where they are approached by brokers to quote for specific kidnap risk exposures. Before entering a contract, insurers and brokers ask potential customers detailed questions about their travel plans and risk mitigation strategies (Lobo Guerrero 2007).¹⁹ This addresses adverse selection. Certain operations are

¹⁹See the application form for corporate special risks insurance at Aspen for the details required.

<http://www.aspen-apj.com/globalassets/corporate-contingency-proposal-form-g.pdf>

deemed “not insurable”, requiring customers to revise their business or travel plans – or turn to their governments for protection (see Haufler 1997, 1999).

If an insurer underwrites a specific activity, the contract directly addresses moral hazard. Firstly, the insured must not relax their vigilance. A company buying kidnap insurance on behalf of its employees is not allowed to disclose this to its staff members (Marsh 2011, Lobo-Guerrero 2007). Disclosing the insurance cover invalidates the contract. Most insurers demand / offer (discounted) training and thorough security (Terra Firma 2014). Employees are trained to avoid risk and receive advice on how to behave in the event of a kidnap. Insurance cover is only available up to a maximum ransom limit set at the level the firm or family could afford to pay in the absence of insurance. In the event of a kidnap the insured must raise the cash themselves and the insurance contract cannot be used as collateral to obtain a bank loan (Terra Firma 2014). The ransom is reimbursed (up to the pre-agreed threshold) by the insurer after the case has concluded.

Monitoring of contracts is done by brokers: they compare the quotes and contractual conditions of the various underwriters before making recommendations to their customers. Insurers therefore quickly find out about new products which divert customers away from them. Reinsurers also scrutinise contracts, leading to a convergence of standards by refusing reinsurance or demanding a high premium for underwriting high-risk, non-standard contracts (Cutler et al 1999). Loss adjusters monitor clients’ adherence to the terms of the contract if they file a claim: examples of “self-kidnapping” and collusion with criminals abound (Lopez 2011, NYT 1981 and Telegraph 2008). The syndicates evaluate which innovations are both profitable and sustainable – copying from other market participants. Risky strategies usually fail in the medium term, leading to market exit.

Intervention on insurance contracts may be required vis-à-vis customers, experts and insurers. If customers are suspected of a breach of contract or fraud, reimbursement is withheld and the case is disputed in court. Underwriters, brokers, and loss adjusters can be dismissed and unsuccessful products can be discontinued. Intervention between insurers may be necessary if a syndicate's lax contract conditions undermine the entire market rather than just the individual enterprise. The kidnap for ransom insurance market is highly vulnerable to myopic behaviour. Insurers can always undercut competitors, collect premium income, and default when losses mount up. Additionally, kidnap for ransom insurers who economise on expert fees confer externalities to the rest of the sector. Unaware targets and quick payments of large ransoms create kidnapping booms – which are problematic for all insurers (Shortland 2016, UN 2013, Wright 2009). The vast majority of kidnap insurance is underwritten or reinsured by member syndicates of Lloyd's of London (Shortland 2016). Syndicates have to renew their membership on an annual basis. The Lloyd's corporation can close any syndicate which acts in contravention of the market's interest (Lloyd's Annual Report 2011 p8). This results in a remarkable degree of consistency in practices across firms (Smets et al 2012).

5.2 Governance Domain (B): prevention and the “business risk” consultancies

With escalating ransoms for high profile executives in Latin America in the early 1970s insurers realised that they must actively manage their exposure. Crucially, the number of incidents had to be reduced: i.e. *“the emphasis [is put] on prevention rather than insurance”* (Bankrate 2012). The business risk consultancy Control Risks was founded as part of the travel insurer Hogg Robinson in 1975 (The Telegraph 2007). With the backing of Lloyd's insurance brokers, Control Risks developed new “kidnap and ransom” insurance policies, where its staff

(mostly ex-SAS officers²⁰) provided security consulting as a condition of insurance against terrorist or criminal threats (Hagedorn Auerbach 1998). In 1980-81 the company was bought out by five members of its management team. Control Risks operates as an independent company, but is retained by Hiscox, the world's largest underwriter of Kidnap and Ransom insurance.

Crime prevention is at the core of its business: *"Control Risks Group Holdings Ltd. provides risk consultancy services to organizations for managing political, integrity, and security risks in complex and hostile environments. It supports clients by providing strategic consultancy..., and providing practical on-the-ground protection and support."*²¹ The close link between insurers and "business risk consulting" is replicated across the industry (see Appendix).

Business risk consultants advise on firms' travel plans or permanent operations in territories where formal law and order are weak. The consultants recommend reliable hotels, transport services and transit routes. Where the risks are higher, they give advice on how to obtain effective protection. The local "protectors" may be off-duty police officers or private guards – sometimes linked to the mafias, insurgents and warlords studied in the criminal governance literature (e.g. Sabates-Wheeler and Verwimp 2014). However, the insured are not involved in illegal transactions. Protection payments are "above board", e.g. the insured pay a legitimate company for guards or accommodation in a "safe" compound. In particularly complex security environments clients obtain private military security – often from the business risk consultancies themselves.

²⁰ The Special Air Service (SAS) is the UK's elite special forces unit.

²¹ <http://www.bloomberg.com/research/stocks/private/snapshot.asp?privcapid=128436>

Indeed, the probability of being kidnapped when insured for kidnap for ransom is low. Clutterbuck (1987 p:100) estimated that of 2400 reported kidnap cases between 1976 and 1986, only 3.5% were insured cases. Control Risks' website advertises the company's experience of resolving just over 2800 cases of "*kidnap, piracy, extortion, threat and illegal detention*". This is not an excessive number of kidnaps in over 40 years in the business. Similarly, Terra Firma (2015) reports "*almost 100*" kidnaps of Chinese workers worldwide since 2001, but with an expatriate workforce of at least one million in 2014 this is a low figure. Lopez (2011 p:xiv) also points out that "*90 per cent of kidnappings globally are locals, not expats or tourists*". Ochoa (2012) shows that Mexican kidnappers deliberately changed strategy to target poorer, low profile victims to evade the pressures the well-resourced and well-connected brought to bear against criminal gangs.

The mandated standards for prevention vary between insurers and over time. Partially, they depend on the risk appetite of the insurer. The market leaders spend less time scrutinising individual travel plans: they can absorb occasional losses from their premium income. Smaller insurers are more risk averse, but reward careful risk mitigation with lower insurance premia. Prevention measures constantly evolve and adapt to changing security environments. The monitoring is done by criminals: unsuccessful prevention costs insurers dearly and undermines the credibility of the risk consultancy. In turn, the business risk consultants hold ineffective protectors to account. Private protection is a lucrative business: e.g. The Guardian (2012) reported that Shell spent \$383million on protecting its staff and installations in the Niger Delta between 2009-2012.²² As the consultancies can redirect their

²² This does not imply that Shell is insured for kidnaps, large multinationals often self-insure.

customers to other areas or different protectors, it is in the protectors' interest to deliver the promised services.

Firms employing business risk consultants evaluate the effectiveness of prevention by looking at their bottom line: insufficient standards generate losses and overblown security measures reduce company profits. Intervention and enforcement therefore takes the form of employing successful business risk consultancies, who provide effective security at the lowest price. In turn, risk consultancies need to ensure that firms do not cut corners on prevention. Taking advice or buying protection is not necessarily mandatory. However, there is an implicit threat that firms will be sued in case of preventable abductions (Interviews III, XII, XIII). Retired and freelance risk consultants stand ready to serve as expert witnesses on whether a firm has followed "best management practice" in the case.²³ If firms correctly follow security advice, their insurance includes cover for "legal liabilities" should employees take legal action (Marsh 2011).

5.3. Governance Domain (C): Resolution and the "crisis response" consultancies

The resolution of kidnap for ransom is the domain of "crisis response" consultancies. These are usually specialist units within the business risk consultancies, though some are "in house" teams (e.g. at Tokio Marine). Crisis responders employ expert negotiators to order transactions with criminals and contain ransoms by taking control of ransom negotiations. Again, Control Risks was the first mover in the field in 1975 (Campbell 2002, Clutterbuck 1978,

²³ Business risk consultants also provide expert witness services when uninsured firms are sued over a breach of "duty of care". This creates additional demand for their services – and ultimately insurance.

1987, Hagedorn Auerbach 1998). *"In the event of a kidnap, Control Risks will deploy a consultant [who] will evaluate the circumstances, advise on possible options and explain the likely sequence of events. He or she will advise on negotiation strategies, [and] undertake appropriate liaison with all interested parties."*²⁴ Other insurers noted the success of this innovation: Ackermann was founded in 1977 and Neil Young Associates in 1990. The massive expansion of the "political risks" insurance market in the 2000s saw the foundation of several further crisis responders (see Appendix). Expert ransom negotiators ensure hostage safety and encourage stakeholders how to minimise the ransom.

5.3.1 Ordering the trade in hostages

Insurers need to incentivise kidnappers to treat their hostages well and release them on payment of the ransom. Insurance turns transnational kidnapping into a repeated game: kidnappers can be rewarded for smooth resolutions and punished for violence and cheating in subsequent encounters. A Mexican kidnapper revealed this perception in the criminal community: *"... his treatment [of the hostage] would act as a calling card for future hostages... no-one's going to negotiate with someone who has a track record of blowing his victims' brains out."* (Lopez 2011 p:70). The crisis responders keep extensive case files and consultants develop specialist knowledge in particular kidnap areas (Interviews III, IV, V, VI, XII, XIII). Relevant information is shared in the community of hostage negotiators. These are largely drawn from the elite military forces and many of them are members of the Special Forces

²⁴ <https://www.controlrisks.com/en/services/security-risk/crisis-management/kidnap-preparedness-and-response> accessed March 2016

Club in London (Campbell 2002, Interviews IV, V, VI).²⁵ As members of a close-knit community they can informally co-operate, communicate and exchange sensitive information. Furthermore, the underwriters of kidnap insurance communicate the outcomes of their cases in the Underwriting Room at Lloyd's.

Information-sharing incentivises smooth resolutions - particularly if there is a credible threat of employing state security forces against violent or cheating kidnappers. Most kidnappers operate in states with some capacity to enforce law and order (e.g. Mexico, Nigeria, Colombia, Pakistan) or in "failed states" where elite troops could directly intervene on behalf of their citizens (e.g. Afghanistan, Somalia). Ochoa (2012) shows that gang survival and profitability depends on staying "under the radar". Mexican police cracked down on violent gangs and those targeting specific communities which organised themselves to pressure the government to take action. Victims' representatives generally have a choice between using "commercial resolution" and involving the security forces.²⁶ As many hostages have perished alongside their captors in rescue operations, this tactic is only attractive if the hostage's life is under threat (Clutterbuck 1987, Lopez 2011). If criminals build reputations for returning unharmed hostages and reliably releasing their victims on payment of the agreed ransom – i.e. orderly commercial resolution - the security forces are kept at arms' length.²⁷ Maritime lawyer Stephen Askins illustrates this "carrot and stick" approach regarding Somali piracy (House of Commons 2012, p57): *"In a commercial sense, we would*

²⁵ See the Ackerman and Red 24 teams for examples <https://www.ackermangroup.com/#team> and <https://www.red24.com/nonmembers/specialists.php>

²⁶ Lopez (2011) even mentions a case in which a private security company offered a "rescue" option

²⁷ Once the hostage is safely returned, risk consultancies co-operate with the police to reduce the risk of future kidnaps.

rather there was minimum government involvement in the negotiation process. They can help where help is called for, but generally we get it, we understand it, we have a process and, on a commercial level, it works."

If formal law-enforcement is not a credible threat, torturing and killing some hostages may raise ransoms for future victims - as Leeson (2010) showed for pirates employing "torture- for-reputation". In inaccessible areas (e.g. Afghanistan, Syria and Iraq) rescues are likely to fail for lack of information. If the police are potentially complicit in kidnapping, criminals can also become more violent (e.g. Russia, Mexico and Pakistan). Even so, crisis responders only proceed with ransom negotiations with proof of life and proof of possession by the kidnappers – preferably a direct telephone conversation with the victim or answers to questions only the victim would know (Lopez 2011, Terra Firma 2014). Consultants also use informal channels of communication through local elites (or a "government in exile") to put pressure on the kidnappers (Interview IV). Crisis responders therefore order transactions at the legal / criminal interface. Their other role is to prevent moral hazard among the insured regarding ransom payments.

5.3.2 Ransom Discipline

Stakeholders faced with threats to their loved one might try to settle quickly for the maximum insured amount or however much ransom they can raise. But high ransoms might change kidnappers' expectations of how much hostages are "worth" and influence concurrent and subsequent negotiations (Terra Firma 2014 p:2). This can then set in motion a vicious cycle in which more criminals enter the kidnapping business, demand higher ransoms, which

– if paid – generate further kidnaps (Shortland 2016, UN 2013, Wright 2009). Kidnapping is only stable as long as there are no super-normal returns.

When a kidnap occurs, the insurer's "crisis responder" immediately dispatches one or two consultants with significant prior negotiation experience and any relevant information about previous and concurrent kidnaps in the region to advise the family or company on how to negotiate the ransom (Clutterbuck 1987, Lobo-Guerrero 2007, Lopez 2011). Professional negotiators reassure the family and steer the negotiation towards a target settlement appropriate to the case and region – rather than their own financial position. *"In every country in the world where there is a kidnapping issue, there is more or less an established market for how much you're going to end up paying. In Mexico, it's \$300,000 to \$1 million. In Honduras, it's \$100,000 to \$300,000 and so forth."* (Bankrate 2012). Negotiations led by professionals usually settle for a small percentage of the originally demanded ransom (Clutterbuck 1987, Lopez 2011, March 1988, Interviews IV, V).

Insurers cannot force victim stakeholders to act in the interests of the insurance industry. All decisions are made by the stakeholders in the best interest of "their" victim – risk consultants only offer advice. However, the literature in social psychology, neuroscience and experimental economics shows that "high credibility" sources affect decisions, especially for risky choices (Klucharev et al 2008). Indeed, the consultants are highly skilled in conducting negotiations and most have a long track record. As former elite military personnel they are naturally competitive and thrive in adversarial situations. They remain calm in stressful situations and understand the criminal mind-set and psychology (Interview IV, Lopez 2011, March 1988). Their military experience is useful for planning ransom drops and the

evacuation of released hostages (Interviews IV and V). Worried stakeholders therefore usually welcome professional support (Interviews X, XI and XV, March 1988).

Lopez (2011) and March (1988) explain how professional negotiators control the negotiations. A communicator is nominated to relay information between the kidnapper and the decision-makers. A Crisis Management Team deliberates on each development or revised demand. At each stage the consultant offers the decision-maker a set of options: *“I make options, they make the call. That’s how it works”* (Lopez 2011 p:103). Stakeholders wishing to settle early are warned against a “double cross”, where kidnappers raise their demand if the stakeholders accede, rather than releasing the hostage (Interviews III, IV, V, March 1988, Terra Firma 2014 p:4). Even if kidnappers return the hostage, firms and families which quickly pay large ransoms are attractive future targets (Lopez 2011, p:113, Wright 2009). Most stakeholders therefore go through the *“theatre”* of mimicking the behaviour of a cash constrained family or firm, slowly raising their offers in decreasing increments to converge at an appropriate settlement for the case (Catlins 2012, Lopez 2011, March 1988, Interviews I, III, IV, V, XI). By limiting ransoms and increasing the negotiation time insurers reduce the attractiveness of kidnapping as a business model.

5.3.3. Setting and maintaining standards

The original standard for the resolution of hostage crises was set by Control Risks, but the techniques were swiftly copied by Ackermann and Neil Young. With the explosion of demand for kidnap for ransom insurance after 2000, former employees of these agencies set up their own businesses. The established protocols (separation of communicator from decision-maker, disruptive bargaining, diminishing increments) are generally observed

(Interviews III, IV, V, VI). The evaluation of crisis response consultants is carried out by criminals, who are quick to spot a weak negotiator - or one who has lost control over the stakeholders and media coverage of a case. Expert quality can thus be easily ascertained from their track record: ransoms, negotiation durations and customer satisfaction.

Enforcement of standards occurs through an active market for good negotiators. Only the largest crisis responders have permanent staff. Most negotiators are employed on a case-by-case basis (Interviews IV, V, VI). Response consultants know each other's reputations: a track-record of clean and cheap resolutions guarantees an attractive income stream. A bungled negotiation is problematic and in extreme cases inept consultants are taken off their case (Lopez 2011). The experts' common military background creates a supportive network in which information is exchanged and advice is available, aiding the convergence of practices (Interviews III, IV, V, VI). Ultimately, however, only effective crisis responders are retained by the insurers to handle their cases. It is therefore in the interest of the crisis responders to evaluate their staff and headhunt effective negotiators.

6. Discussion

Table 2 summarises the governance architecture for kidnap for ransom, created by the underwriters of kidnap for ransom insurance to limit, order and stabilise the trade in hostages. There are a number of interesting features.

- Insert Table 2 here -

The first is the key role of experts in setting and adapting standards in an evolving threat situation. There are three types of experts: underwriters set standards for transactions with customers, business risk consultants deal with prevention and crisis response consultants order the trade in hostages.²⁸ Within each area, the experts share norms, a policy enterprise, beliefs and criteria for evaluating new evidence. Each set of experts thus forms an “epistemic community”. Underwriting at Lloyd’s is a long-term, “*boy-to-man*” profession (Interview XVI). Communication is facilitated by the physical proximity of experts in the underwriting room and a shared concern for system stability (Interviews V, XVI). In domains (B) and (C) the epistemic community is underpinned by recruitment from elite military and law enforcement units.

The second key feature is that syndicates evaluate whether standards are maintained (or have been successfully adapted) by looking at the profits and losses for their risk exposures. This underlines the insight from the private governance literature that providing governance is a business. In kidnap for ransom some business models work – and some are more profitable (and sustainable) than others. Effective governance reduces losses, so insurance premia can be lowered. Successful innovators quickly gain market share and

²⁸ In the smaller consultancies some experts are both risk consultants and crisis responders.

competitors either have to adapt or cease underwriting. When new risks emerge there is a flurry of product development – e.g. “hijack for ransom” insurance in response to Somali piracy. As ransoms escalated, many boutique insurers suffered heavy losses and withdrew from the market (House of Commons 2012). There are also mergers and take-overs if a syndicate has an attractive “book” but wishes to exit from underwriting specific risks. As the system relies on expert governance and there is a competitive market for expertise, the fluidity of the syndicates’ underwriting activity is of little practical consequence. What matters is that the underwriting, risk evaluation, security advice and crisis resolution are delivered by the best experts in their respective fields.

The third key feature of the governance architecture is the use of contracts to enforce standards and reward successful innovation. Contracts specify the insured’s obligation to prevent and limit the extent of the criminal damage. This is monitored by loss adjusters and enforced by courts. Many consultancies are on short-term or even case-specific contracts with the insurers, creating intense pressure to provide value for money. In turn, the smaller consultancies employ experts for specific cases based on their performance record (Interviews V and VI). Criminal gangs constantly test the efficacy of prevention measures and the quality of negotiators. Only outstanding experts are in full-time, salaried employment.

The fourth key feature is the role of Lloyd’s in stabilising the market (Shortland 2016). Although underwriters and consultants experiment with new products, processes and techniques at the margin, certain business practices are central for system stability and form part of the standard Lloyd’s protocol. The necessary information to price kidnap insurance correctly is only shared among underwriters with syndicates at Lloyd’s. Therefore membership of Lloyd’s is crucial for profitability. The Lloyd’s Corporation’s explicit threat to

exclude any syndicate which imposes costs on the rest of the sector underpins the entire governance architecture (Lloyd's Annual Report 2011 p8).

The final key feature is the polycentric nature of the governance system (Aligica and Tarko 2013). The beneficiaries of a well-governed trade in hostages are insurers, the insured, criminals and ultimately states, who use the private governance system to safeguard the security of their citizens abroad. Governance is co-produced by these various actors.

7. Conclusion

The paper argues that insurers take the lead role in governing criminal kidnap for ransom. Kidnap insurers require their customers to engage in active security management and offer business solutions to prevent kidnapping. Although the insured are financially attractive kidnapping targets, transnational kidnaps are relatively rare. When kidnaps occur, insurers have devised a resolution system which returns the vast majority of hostages safely without stimulating the expansion of kidnapping. Experts play a key role in setting and applying standards. The effectiveness of these standards (and customer compliance with them) is tested by the criminal underworld. Criminal successes translate into financial losses and economic agents draw the appropriate consequences. Fraud, negligence and recklessness are dealt with through the formal institutions of courts and the Lloyd's corporation. The governance system adapts to changes in economic opportunities, criminal tactics and the legal framework. When governance works, providing kidnap for ransom insurance is lucrative. Otherwise, the personal and financial consequences can be catastrophic.

Governing criminal markets involves facilitating transactions which are not widely accepted as “ethical” business behaviour, such as employing private protection and paying ransoms to criminal and insurgent groups. However, most people agree that it is in the national interest that a country’s firms operate in emerging markets, that NGOs deliver aid, journalists report from conflict zones and that oil and minerals are extracted. If companies and NGOs have a duty of care towards their employees then orderly resolution of kidnaps is invaluable. Governance of international transactions at the criminal / legal interface cannot be delivered by home governments. Therefore insurers have created the necessary institutions to order such transactions. Buchanan (1973) argued that governance of criminal markets reduces overall crime. Indeed, the insurers’ profit motive results in the reduction of social “bads”: kidnappings and the number of hostages killed are low and transfers to kidnappers are reduced. Kidnap insurance allows companies to pursue profit opportunities in weak states and yet fulfil their duty of care to their employees. By providing formal governance facilities to insurers the state tacitly supports the private governance regime.

This pragmatic recognition of the benefits of orderly transactions in criminal kidnaps begs the question why governments explicitly exclude insurers from ordering “terrorist” kidnap for ransom. An outright no-negotiation stance is politically problematic and ultimately not credible (Block and Tinsley 2008, UN 2013, White House Briefing 2015). Some governments regularly pay multi-million dollar ransoms to terrorist organisations (NYT 2014): they have soft budget constraints and short time horizons as they usually conduct negotiations in the media spot-light. There is no mechanism to internalise the spill-overs of premium ransom payments on hostages from other nations. The US recently changed policy to permit families to ransom loved ones (White House Briefing 2015). Most families have

lower budgets than governments, but crowd-funding and philanthropic donations can undermine ransom discipline even here. Recent ransom inflation and the murder of hostages from non-negotiating nations suggest that the governance vacuum for “terrorist” kidnaps is increasingly filled by terrorist organisations. Al Qaeda, IS and Boko Haram are establishing reputations for orderly commercial resolutions at premium prices - and death otherwise. They are reaping the financial rewards of providing governance, as criminal and opportunistic kidnappers pass hostages to them (Safer Yemen 2014 pii, Interviews V, XIII). It is in the public interest that these unintended consequences of the present policy are recognised. Future policy should be informed by a careful analysis of the private regime ordering criminal kidnap for ransom.

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Interview VII: Attorney (March 2012)

Interview VIII: Attorney (April 2013)

Interview IX: FCO official (January 2015)

Interview X: Per Gullestrup, Former CEO, Clipper Shipping Group (January 2015)

Interview XI: Ship owner and piracy victim (February 2015)

Interview XII: Employee Crisis Response Company (February and March 2015)

Interview XIII: Employee Crisis Response Company (January 2015)

Interview XIV: Partner Crisis Response Company (April 2013)

Interview XV: Family member of kidnap victim (June 2013)

Interview XVI: Insurance specialist (June 2015)

Table 1: Governance domains and governance functions in kidnap for ransom

Table 1		Regulation Functions				
		Standard-setting		Monitoring and Evaluation		Intervention
Governance domains	Insurance contracts (A)					
	Prevention (B)					
	Resolution (C)					

Producers of governance: split cells indicate co-production

	Legal Private		Criminal		Government
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Table 2: Governance architecture in kidnap for ransom

Table 2		Governance Functions			
		Standard-setting	Monitoring	Evaluation	Intervention
Governance domains	Insurance contracts (A)	Expert underwriters	Brokers, Reinsurers, Loss adjusters	Syndicate profit / loss	Courts for “compliance”
					Employers of experts
					Lloyd’s corporation
	Prevention (B)	Expert business risk consultants / Mafias	Criminal gangs	# of Kidnaps and value of targets	Courts for “Duty of Care”
				Syndicate profit / loss	Employers of experts
	Resolution (C)	Expert crisis response consultants / Mafias	Criminal gangs	Ransom / duration / violence	Courts for “Duty of Care”
				Syndicate profit / loss	Employers of experts
					Lloyd’s corporation

Appendix: K&R insurers and associated consultancies (March 2016)

Insurers	Business Risk Consultants	Crisis Responder(s)
ACE	Red 24	Red 24
AIG	Neil Young Associates	Neil Young Associates, MS Risk
ANV	MS Risk	MS Risk, “expert consultants”
Aspen	AKE, Henderson Risk	Aegis Response, Henderson Risk
Beazley Furlonge	Red 24, Hazelwood Street Consultants	MAST, Hazelwood Street Consultants, Red 24
Canopus	“Supported by expert crisis consultants”	“Supported by expert crisis consultants”
Chubb	Ackermann	Ackermann
CV Starr	Neil Young Associates	Neil Young Associates
DUAL (Hyperion)	MS Risk	“expert consultants”, MS Risk
Griffin	Security Exchange 24	Security Exchange 24
Hiscox	Control Risks	Control Risks
Houston Casualty	Unity Resources	Unity Resources
Ironshore	Hazelwood Street Consultants	Hazelwood Street Consultants
Liberty	Unity Resources	Unity Resources
Tokio Marine Kiln	Not currently marketing K&R insurance	“In house” response team
Travelers	Olive	Olive
QBE	Red 24	Red 24
XL Catlin	Terra Firma, Red 24, Compass Risk Management	Terra Firma, Red 24, Compass Risk Management